



STATE OF WASHINGTON

## ECONOMIC AND REVENUE FORECAST COUNCIL

Capitol Plaza Building, PO Box 40912 • Olympia, Washington 98504-0912 • (360) 570-6100

August 31, 2006

**TO:** Governor's Council of Economic Advisors

**FROM:** ChangMook Sohn, Executive Director  
Economic and Revenue Forecast Council

**SUBJECT: PRELIMINARY SEPTEMBER ECONOMIC FORECAST**

This preliminary forecast was based on Global Insight's August Control forecast for the U.S. economy. You should have received a summary of the Global Insight forecast by email. If not, please contact our office. The forecast incorporated the advance GDP estimate for the second quarter of 2006. According to the advance estimate, real GDP grew at a 2.5 percent rate in the second quarter of 2006, down sharply from 5.6 percent in the first quarter. The slowdown in final sales was even sharper, from 5.6 percent to 2.1 percent. The weakness in the second quarter was widespread. Consumer spending slowed to a 2.5 percent annual rate as purchases of durable goods fell at a 0.5 percent rate. Fixed investment declined at a 0.7 percent rate. Residential fixed investment fell 6.3 percent and business spending on equipment and software declined 1.0 percent, which was the first drop in more than three years.

Payroll employment growth slowed to 1.2 percent in the second quarter from 1.7 percent in the first quarter and a Katrina-adjusted 1.7 percent in the fourth quarter of last year. The unemployment rate dipped slightly to 4.63 percent in the second quarter from 4.73 percent in the first quarter. Inflation, as measured by the Consumer Price Index, jumped to 5.0 percent in the second quarter of 2006 from 2.2 percent in the first quarter. The increase was largely due to surging energy costs but core inflation, which excludes food and energy, increased from 2.4 percent to 3.5 percent. Housing starts plummeted at a 38.7 percent rate in the second quarter to 1.878 million units from a nearly 33-year-high 2.123 million units in the first quarter. The mortgage rate jumped to 6.60 percent in the second quarter from 6.24 percent in the first quarter.

The new national forecast anticipates considerably higher oil prices than the forecast adopted in June. Oil prices (West Texas Intermediate) are now expected to rise to \$78 per barrel in the fourth quarter of 2006 versus \$67 assumed in June. Oil prices are expected to decline throughout 2007, 2008, and 2009, but they will still be \$10 to \$15 per barrel higher than previously assumed throughout this period. Largely as a result of the more pessimistic oil price outlook, the new forecast features both higher inflation and lower real growth than the forecast adopted in June. The Federal Reserve held interest rates steady on August 8, giving priority for now to the risk of over-tightening. But the forecast assumes that inflation risks will lead the Fed to hike one more time, on September 20, taking the federal funds rate to a peak of 5.50 percent.

A comparison of the preliminary U.S. forecast with the forecast adopted in June is shown in Table 2.

The Washington aerospace employment forecast is virtually unchanged since June. As of July, the aerospace sector has added 12,200 jobs since the trough in May 2004. The forecast expects another 7,300 new aerospace jobs by mid-2008 when employment is expected to level off at 80,300. This is still 32,800 (29.0 percent) lower than the previous peak in June 1998. The software wage forecast has been raised by about \$600 million per year mainly as a result of higher than previously expected actual wages in the second quarter of 2006. Software employment is expected to grow about 7,400 from now through the end of 2009 which translates into a growth rate of 2,100 jobs per year. Higher interest rates will have an adverse impact on the Washington housing market but this will be offset by strong population growth. In addition, nonresidential construction is expected to recover. Overall Washington construction employment is expected to continue to expand but at a much reduced rate.

This forecast also incorporates newly available Quarterly Census of Employment and Wages (QCEW) data for the first quarter of 2006. The benchmark revision to the first quarter lowered the estimate of March employment by 9,100. In addition, employment growth from March through July was 5,000 weaker than expected, leaving July's employment 14,100 lower than expected in the June forecast.

We have more up-to-date QCEW data for wages in the fourth quarter of 2004 and all four quarters of 2005 than did the Bureau of Economic Analysis (BEA) at the time of their latest state personal income release. In addition, we have the QCEW data for the first quarter of 2006 which was unavailable to the BEA at the time of their latest personal income release. As a result, our estimates of wages in those quarters differ from the published BEA estimates. The QCEW data indicate that first quarter wages were \$3.320 billion higher than expected in June. Software wages were \$0.279 billion higher than expected and other wages were \$3.041 billion higher. Nonwage personal income was \$0.446 billion below the June estimate. The revision to total personal income in the first quarter was net increase of \$2.875 billion.

The surprising strength in wages in the first quarter is perhaps the major change to the Washington forecast. According to the QCEW data, average wages (excluding software) soared at an average annual rate of 13.9 percent in the first quarter compared to the 4.6 percent rate expected in the June forecast. The stronger than expected growth in the first quarter added 2.2 percentage points to average non-software wage growth and 1.2 percentage points to personal income growth in the 2006 calendar year. The stronger first quarter wage growth explains virtually all the revision to annual personal income growth in 2006. The August 31 U.S. personal release, which was the first to incorporate QCEW data for the first quarter, shows a similar surprising jump in U.S. wages but these were not available at the time the national forecast was prepared.

The forecast also reflects Seattle consumer price data through June. After trailing the national average during 2002, 2003, and 2004, December-December Seattle core inflation (excluding food and energy) edged ahead of the national average, rising 2.3 percent compared to 2.2 percent. During the first six months of 2006 core inflation in Seattle rose at an annual rate of 3.5 percent compared to 3.2 percent for the U.S. city average. Because energy prices rose more locally than elsewhere in

the U.S., the gap in overall inflation was even larger. The overall Seattle CPI rose at an annual rate of 5.2 percent in the first six months of this year compared to the 4.7 percent national average.

The number of housing units authorized by building permit rose 3,700 in the second quarter of 2006 to 51,200 from 47,500 in the first quarter. Single-family permits edged down 400 to 35,300 but multi-family permits rose 4,200 to 15,900. Multi-family permits jumped to 26,000 in July which was the highest monthly figure since December 2000. Single family permits fell to 29,300, however, which was the lowest rate since March 2002.

A comparison of the preliminary Washington forecast with the forecast adopted in June is shown in Table 3.

Review of the forecast by the Governor's Council of Economic Advisors is scheduled for Wednesday, September 6, 2006 at 10:00 a.m., in the Governor's Conference Room.

If you have any questions, please contact Bret Bertolin, Senior Economic Forecaster, at (360) 570-6106.

**PLEASE NOTE:**

Enclosed is a worksheet summarizing the preliminary forecast. **Council members are strongly encouraged to complete and return this worksheet either in person at the Governor's Council meeting or, if unable to attend, by FAX to (360) 753-7022.** This worksheet is relied on by the Forecast Council members and staff to gauge the reasonableness of the preliminary economic forecast and also serves as the basis of an alternative economic and revenue forecast.

Fluctuations in software wages cause significant distortions in overall wage and personal income trends. In particular, Microsoft's stock awards vest in the third quarter of each year. Microsoft also pays bonuses in the third quarter. Since the Bureau of Economic Analysis does not seasonally adjust software wages, this causes an apparent jump in wages in the third quarter of each year and drop in the fourth quarter. Other quarters are less affected. Also, Microsoft stock option income can vary widely from quarter to quarter and from year to year. The following table shows what growth would have been without these factors.

	2006Q3	2006	2007	2008	2009:1,2
<u>Real Personal Income, %Ch.</u>					
Baseline	11.6	5.2	4.6	5.0	4.3
Excluding Software	4.0	5.0	4.5	4.9	4.8
Difference	7.6	0.2	0.1	0.0	-0.6
<u>Average Annual Wage, %Ch.</u>					
Baseline	18.7	6.9	4.1	4.3	3.4
Excluding Software	4.5	6.7	4.0	4.2	4.5
Difference	14.2	0.2	0.1	0.1	-1.0

Table 1

**U.S. Economic Forecast Comparison**

August 2006

	2006Q2	2006Q3	2006Q4	2007Q1	2006	2007	2008	2009
<b>Real GDP, Percent Change</b>								
Global Insight	2.5	2.3	2.2	2.1	3.3	2.4	3.1	3.1
Blue Chip	2.5	2.7	2.7	2.7	3.4	2.7		
Economy.com	2.5	2.8	3.1		3.5			
S&P	2.5	2.9	2.1		3.4	2.3	3.0	3.1
Merril Lynch	3.3	2.1	2.5	2.0	3.3	2.3		
<b>Federal Funds Rate</b>								
Global Insight	4.91	5.28	5.50	5.50	5.03	5.20	4.75	4.94
Blue Chip*	4.9	5.3	5.3	5.2	5.0	5.2		
Economy.com	4.91	5.43	5.50		5.07			
S&P	4.9	5.3	5.5		5.0	5.3	5.0	5.0
<b>Consumer Price Index, Percent Change</b>								
Global Insight	5.0	3.6	2.2	2.5	3.6	2.5	1.8	1.7
Blue Chip	4.9	3.1	2.5	2.6	3.5	2.7		
Economy.com	5.0	3.0	2.6		3.6			
S&P	5.0	3.6	2.2		3.6	2.5	1.8	1.6
Merril Lynch	5.0	2.7	0.8	0.7	3.4	1.3#		
<b>Payroll Employment, Millions</b>								
Global Insight	135.1	135.5	135.9	136.2	135.3	136.8	138.7	140.6
Economy.com	135.1	135.7	136.2		135.4			
S&P	135.1	135.6	135.9		135.3	136.8	138.6	140.5
<b>Unemployment Rate, Percent</b>								
Global Insight	4.6	4.7	4.8	4.8	4.7	4.9	4.9	4.8
Blue Chip	4.6	4.7	4.7	4.8	4.7	4.9		
Economy.com	4.6	4.6	4.6		4.7			
S&P	4.6	4.7	4.7		4.7	4.9	5.0	4.8
Merril Lynch	4.6	4.8	4.9	5.1	4.8	5.2		
<b>Real Disposable Personal Income, Percent Change</b>								
Global Insight	1.0	2.9	2.9	4.1	2.1	3.4	4.1	3.7
Blue Chip	1.0	3.5	3.4	3.4	2.3	3.2		
Merril Lynch	1.0	3.2	3.0	2.6	2.2	2.4		

\* Estimate based on T-bill rate.

# Implied by the quarterly pattern. We assumed that the annual number was a misprint.

Table 2

**U.S. Forecast Comparison**

	2005Q4	2006Q1	2006Q2	2006Q3	2006Q4	2007Q1	2005	2006	2007	2008	2009
<b>Real GDP (Billions of Chained 2000 Dollars)</b>											
September	11163.8	11316.4	11385.3	11451.4	11514.8	11575.0	11048.6	11417.0	11692.7	12057.9	12434.2
Percent Change	1.8	5.6	2.5	2.3	2.2	2.1	3.2	3.3	2.4	3.1	3.1
June	11248.3	11381.4	11472.6	11547.8	11627.3	11695.2	11134.8	11507.3	11818.7	12194.2	12590.7
Percent Change	1.7	4.8	3.2	2.6	2.8	2.4	3.5	3.3	2.7	3.2	3.3
<b>Implicit Price Deflator (2000=1.000)</b>											
September	1.129	1.134	1.146	1.154	1.160	1.166	1.115	1.149	1.174	1.196	1.217
Percent Change	2.9	2.0	4.1	2.8	2.0	2.2	2.9	3.0	2.2	1.9	1.8
June	1.126	1.132	1.143	1.146	1.148	1.153	1.113	1.142	1.160	1.180	1.199
Percent Change	2.9	2.0	3.8	1.4	0.6	1.9	2.8	2.6	1.6	1.7	1.6
<b>Real Personal Income (Billions of Chained 2000 Dollars)</b>											
September	9288.0	9385.6	9435.1	9503.3	9575.2	9656.6	9183.2	9474.8	9776.2	10146.1	10558.0
Percent Change	5.8	4.3	2.1	2.9	3.1	3.4	2.3	3.2	3.2	3.8	4.1
June	9307.5	9401.0	9458.2	9559.5	9675.9	9771.7	9206.4	9523.6	9907.1	10284.9	10700.8
Percent Change	6.4	4.1	2.5	4.4	5.0	4.0	2.6	3.4	4.0	3.8	4.0
<b>Wage and Salary Employment</b>											
September	134.16	134.72	135.13	135.49	135.86	136.21	133.46	135.30	136.82	138.71	140.59
Percent Change	1.2	1.7	1.2	1.1	1.1	1.0	1.5	1.4	1.1	1.4	1.4
June	134.16	134.73	135.26	135.82	136.27	136.76	133.46	135.52	137.47	139.39	141.09
Percent Change	1.2	1.7	1.6	1.7	1.3	1.5	1.5	1.5	1.4	1.4	1.2
<b>Unemployment Rate</b>											
September	4.93	4.73	4.63	4.73	4.77	4.84	5.06	4.72	4.91	4.92	4.75
June	4.93	4.73	4.68	4.67	4.71	4.77	5.06	4.70	4.83	4.81	4.65
<b>Mortgage Rate</b>											
September	6.22	6.24	6.60	6.77	6.81	6.80	5.86	6.60	6.80	6.99	7.25
June	6.22	6.24	6.54	6.84	6.71	6.78	5.86	6.58	6.75	6.78	7.10
<b>3 Month T-Bill Rate</b>											
September	3.82	4.43	4.68	5.08	5.35	5.35	3.14	4.88	5.04	4.66	4.80
June	3.82	4.43	4.77	5.04	5.04	5.03	3.14	4.82	4.78	4.58	4.78

Table 3

**Washington Forecast Comparison**

	2005Q4	2006Q1	2006Q2	2006Q3	2006Q4	2007Q1	2005	2006	2007	2008	2009
<b>Real Personal Income (Billions of Chained 2000 Dollars)</b>											
September	202.088	207.062	208.441	214.245	213.614	215.879	200.364	210.840	220.447	231.360	242.596
Percent Change	0.1	10.2	2.7	11.6	-1.2	4.3	0.1	5.2	4.6	5.0	4.9
June	202.010	204.977	206.306	212.854	213.139	215.842	200.647	209.319	220.697	231.446	242.452
Percent Change	-1.3	6.0	2.6	13.3	0.5	5.2	0.1	4.3	5.4	4.9	4.8
<b>Personal Income</b>											
September	228.086	234.883	238.860	247.236	247.740	251.757	223.392	242.180	258.894	276.807	295.342
Percent Change	3.0	12.5	6.9	14.8	0.8	6.6	2.9	8.4	6.9	6.9	6.7
June	227.520	232.008	235.710	244.011	244.693	248.965	223.346	239.106	256.096	273.156	290.630
Percent Change	1.5	8.1	6.5	14.8	1.1	7.2	2.9	7.1	7.1	6.7	6.4
<b>Wage and Salary Employment</b>											
September	2809.8	2839.5	2851.4	2867.0	2881.6	2898.2	2777.3	2859.9	2922.8	2987.6	3042.5
Percent Change	3.9	4.3	1.7	2.2	2.1	2.3	2.8	3.0	2.2	2.2	1.8
June	2810.2	2845.7	2864.3	2882.6	2898.5	2916.8	2777.6	2872.8	2942.2	3004.5	3054.6
Percent Change	3.6	5.2	2.6	2.6	2.2	2.6	2.8	3.4	2.4	2.1	1.7
<b>Manufacturing Employment</b>											
September	277.0	281.8	282.6	284.4	286.8	289.7	272.0	283.9	291.0	292.8	293.1
Percent Change	11.0	7.2	1.1	2.6	3.5	4.1	3.1	4.4	2.5	0.6	0.1
June	276.9	280.1	282.5	284.8	286.0	288.2	271.9	283.4	289.2	290.9	290.3
Percent Change	10.8	4.7	3.5	3.2	1.8	3.0	3.1	4.2	2.1	0.6	-0.2
<b>Construction Employment</b>											
September	183.2	190.9	193.2	194.1	194.0	195.1	177.4	193.1	195.9	197.7	198.6
Percent Change	11.2	17.8	5.1	1.8	-0.2	2.3	8.1	8.8	1.5	1.0	0.4
June	183.5	191.9	195.1	195.1	194.8	195.8	177.4	194.2	196.8	198.5	199.2
Percent Change	12.5	19.6	6.7	0.1	-0.7	2.1	8.1	9.5	1.3	0.9	0.4
<b>Housing Permits</b>											
September	57.675	47.516	51.247	50.120	49.662	49.177	52.988	49.636	49.676	48.953	46.643
Percent Change	30.4	-53.9	35.3	-8.5	-3.6	-3.9	5.8	-6.3	0.1	-1.5	-4.7
June	57.675	47.516	48.303	49.195	50.445	49.850	52.988	48.865	50.351	49.205	46.669
Percent Change	30.4	-53.9	6.8	7.6	10.6	-4.6	5.8	-7.8	3.0	-2.3	-5.2

Advisor's Name: \_\_\_\_\_

**Forecast Worksheet**  
**August 31, 2006**

	2006:Q3	2006	2007	2008	2009:1,2
<b><u>U.S.</u></b>					
<b>Real GDP, %Ch</b>					
Baseline	2.3	3.3	2.4	3.1	3.0
Your Opinion	_____	_____	_____	_____	_____
<b>Implicit Price Deflator, % Ch</b>					
Baseline	2.8	3.0	2.2	1.9	1.8
Your Opinion	_____	_____	_____	_____	_____
<b>Mortgage Rate, Percent</b>					
Baseline	6.8	6.6	6.8	7.0	7.2
Your Opinion	_____	_____	_____	_____	_____
<b>Oil Price (WTI)</b>					
Baseline	75.0	71.7	76.3	73.4	70.3
Your Opinion	_____	_____	_____	_____	_____
<b>Probability next recession begins on or before 2009Q2</b>			_____		
<b><u>Washington State</u></b>					
<b>Real Personal Income, % Ch*</b>					
Baseline	11.6	5.2	4.6	5.0	4.3
Your Opinion	_____	_____	_____	_____	_____
<b>Wage and Salary Employment, % Ch*</b>					
Baseline	2.2	3.0	2.2	2.2	1.7
Your Opinion	_____	_____	_____	_____	_____
<b>Manufacturing Employment, % Ch*</b>					
Baseline	2.6	4.4	2.5	0.6	0.4
Your Opinion	_____	_____	_____	_____	_____
<b>Construction Employment, % Ch</b>					
Baseline	1.8	8.8	1.5	1.0	0.3
Your Opinion	_____	_____	_____	_____	_____
<b>Housing Permits (Thousands)</b>					
Baseline	50.1	49.6	49.7	49.0	47.2
Your Opinion	_____	_____	_____	_____	_____
<b>Washington Average Annual Wage, % Ch*</b>					
Baseline	18.7	6.9	4.1	4.3	3.4
Your Opinion	_____	_____	_____	_____	_____

\* Please see important table on page three of the memo.